The Indo-US Summit

Partnership in Building India's Infrastructure— A Summary of Events[1]

P Nair and Deepak Kumar***

While India's policymakers have increasingly been giving importance to the private sector, as regards the participation and investment in infrastructure, not too many American companies have availed of this opportunity. There have been many issues regarding the regulatory framework, bureaucratic delays etc. All this is set to change. The recent surveys have shown a persistent trend of increasing satisfaction among the overseas investors at the changes that are taking place in India. The situation in the infrastructure sector is not different. The summarized proceedings of the above-mentioned conference are useful in this context, and would serve to update the reader on the developments that are taking place in this important sector. The broad conclusions, as understood by the authors, are reproduced in this article.

Introduction

An interesting development took place with the hosting of an Indo-US summit by the Indo American Chamber of Commerce in February 2005. For the first time, there appears to be a thaw in the Indo-US efforts to put more actual money into the infrastructure sector in India. For long the US has held off, citing reasons such as bureaucracy, quality control, and need for return on investment.

From the approach and attitude of the concerning US officials in the summit, it does appear indeed that their attitude has changed and the level of activity has gone up. India is seen as a genuine long-term strategic partner in the global war on terror, with many permanent characteristics and features such as basic democratic institutions, the widespread use of English and the presence of high quality professionals in a number of disciplines. Indeed, these are the same characteristics, which are necessary to have a fruitful partnership on the infrastructure front also.

* Consulting Editor, *The ICFAI Journal of Infrastructure.*
** Associate Consultant, The ICFAI University Press.

[1] This article is based on the proceedings of the "Indo-US Summit: Partnership in Building India's Infrastructure", organized by Indo-American Chamber of Commerce on 9th and 10th February, 2005, in New Delhi. The content does not purport to be an exact transcription of the conference. The broad conclusions are based on the interpretations of the authors based upon the presentations made by various speakers.

While there is a case for accusing the US of being much finicky about the matters mentioned in the preceding paragraph, there is no doubt that these parameters are also improving steadily, as the society develops. Countries such as China, Malaysia, Russia and Korea have taken greater advantage of the situation and have been able to manage these imperfections much better so far, as compared to the companies of the US and Europe. However (as indicated in the various discussions and presentations) there appears to be a substantial increase in the people to people contact, visits by delegations, etc., which must lead inevitably to more transactions of a more concrete nature, especially if there is an economic basis for such contacts.

We have, therefore, every reason to be encouraged by such developments. The conference, per se, also served a useful purpose in getting the latest data about the progress on various fronts as presented by the senior and responsible professionals and officials from the state on the front line. The gist of the discussions has been culled out and presented for the benefit of the readers. However, this does not purport to be an exact transcription of the events.

Section 1: Roads and Bridges

An excellent presentation was made by the member technical of NHAI on the progress as regards the golden quadrilateral, the problems therein and the details of the next phase. According to Shri Singh, despite many teething problems, NHDP—I is almost complete and would certainly be operational by the end of December 2005. This is undoubtedly a major achievement by the NHAI. Progress would have been faster but for one or two issues, which were discussed briefly below:

a) The nonperformance of contractors—Some contractors had perennial cash flow problems and could not design the project upto standard. They were given one or two chances to improve and then disqualified.

b) Environmental clearances—This took a great deal of time and required the coordination of several ministries. Also, the permission to clear 60 m on either side of the road (as against 20 meters today) was sought.

In the third phase of the NHAI, it was expected that the private sector would play a much greater role in the funding and operation of the roads.

MSRDC gave a presentation on its current operations. It has built the Mumbai-Pune Expressway—perhaps the largest infra structure road project in the country connecting two cities. In addition, they also built over 50 flyovers in Mumbai.

The project cost of the Mumbai-Pune expressway was Rs. 2100 cr. MSRDC had the purpose but no means. The purpose was the alignment of the road and the first time departure from existing alignment but it was a difficult job and terrain as it required extensive network of tunnels and bridges. It had the innovations in designing and implementation in areas such as technology, security, communication facilities, access and planning with a view for the future.

It also had innovations in relationships such as outsourcing of various works, adopting of international practices, international documentation systems (such as –FIDIC), co-opting of contractors, office of the engineer, dispute resolution mechanism and quick decision taker.

The success was due to three major factors viz.,

i) Full political support

ii) Proper financial and operational structuring and

iii) A corporate setup which enabled MSRDC to respond appropriately.

Besides the Mumbai-Pune express way, 50 flyovers were built in Mumbai. The project cost was Rs. 1600 cr. Thirty six bridges were built in 18 months. Some bridges were built in less than 18 months. The secret of success is that MSRDC only laid down the design criteria and time and cost parameters and left the operators to manage the rest of the show. Tolling therefore started early and disputes were dissolved quickly and amicably.

The next project of MSRDC is the Integrated Road Development Projects (IRDP) which covers nine cities in Maharashtra at a project cost of Rs. 1220 cr. This project was a mix of improvement to the existing roads, as well as building new bridges, ROBs and civic amenities. Financing in IRDP was done with a view that large infrastructure projects have a long gestation period and thus need to match long-term sources with long-term needs. Unfortunately long-term capital sources did not exist in India and large projects were financed by the World Bank or other multilateral institutions or parties to the government grants.

The earlier projects of MSRDC had been juggling with a mismatch of assets and liabilities —thus putting a strain on its balance sheet. MSRDC has now decreased the debt and interest rate and the cash flow seems to be positive in 2011. It has now 22 projects and is taking mega projects like sea links and intrastate highways.

Innovation is a continuous process—as land acquisition as a tender item, toll collection, sky space utilization, JV for design and project management, RBI norms and prudential exposure. MSRDC dreams to change the definition of infrastructure by its actions and wants to be in the hill station cities, ports, waterways and airports and can be a revenue driven and total solution provider for project concept, finance and management .

What also came out is that India has extremely strong capability in engineering and design. This had to be leveraged by the US companies and converted into something concrete in terms of projects.

Section 2: Shipping and Ports

The secretary of shipping stated that 95% by volume and 77% by value of the import - export business, are through the ports. The investment and private sector involvement, over the past 4-5 years, has been reasonable and there have been no serious complaints so far. Indeed, the entry of Dubai Port Trust into Vallarpadam is a sign that the Port policy of the country is at least reasonably competitive. However, there is no reason to be complacent on this score and the Union Government is seized of the need to have a common port policy. As a sign of the new transparency and participatory approach, that is being encouraged, the new draft port policy was put on the website, and comments were invited from the experts on the same. This is for the first time that such an action was taken, showing greater openness by the Union Government and willingness to accept the viewpoints of all the stakeholders. This is because the state increasingly sees itself as a facilitator and regulator, rather than an operator.

The government was also committed to the geographic dispersion of the ports, rather than having a concentration in one region only. There was also a firm desire to enhance competition as government monopoly cannot be replaced by a private monopoly.

IDFC had been asked (about six years ago) to evolve a framework, for the development of ports, so that there could be a degree of reliability and consistency in the framework. The earlier practice was for the concerning port trust to issue a licence against a fee, to the contractor concerned. Bidders were expected to guarantee a level of traffic, and pay a royalty on this. The biggest change that has occurred (in which IDFC played a pioneering role) was to evolve a market revenue model. In this model, the risk allocation framework was so allocated that the port trust also had to get its revenue, based on the traffic flow. This also ensured that the Port trust played an active role in facilitating the growth and flow of the traffic, instead of remaining static as was the earlier practice. However, to get these frameworks operational, there were huge skill set and mindset issues involved. The port trusts were not used to the commercial mode of thinking. They are uncomfortable with items which are not guaranteed.

There is also a great deal of difference between a Greenfield and Brownfield port, as regards their risk and return profiles. The brownfield port has at least some track record and history, which could be analyzed, which the Greenfield port does not have. But they also have some unsavory practices which take time to set right. The Greenfield port can set the ground rules, right from the start. Dhabra and Kakinada, on the east coast, are brownfield ports which are being actively looked at, for upgradation, modernization and participation by the private bidders. Finally, the real test in the policy making areas is to come out with model concession licence agreement for both Greenfield and brownfield ports and the indication is that the authorities are gradually becoming more and more successful in doing the same.

An investor wants policies to remain consistent. He is ready to take up normal commercial risks. If investment is desired, then the policy making framework must address the commercial concerns of the lenders and equity investors. Therefore, it is necessary to do the project preparation first and arrive at a shelf of projects which offers realistic competitive terms. It is also highly desirable to get all the clearances for the project upfront. Then the investors could be sourced. Therefore we think of a shelf of readymade projects, which are desired, preparing them suitably, structuring them financially, getting all government clearances, and then offering it to a suitable investor through the process of competitive bidding. In this process, it is found that a reasonable stake by the government adds to confidence—an excessive strike does not do so. The returns should be offered primarily to the investor, and when the project takes off, to the government.

The habit of giving services for free, does not lend itself to a healthy environment. Anything going for free, is an opportunity for the wise to make illegal profits. It is a well known fact that the poor pay a much higher price for many essential commodities than do the rich. The official service has broken down due to misuse and disrepair. Therefore it is always useful to charge a modest fee, even for the socially desirable services.

Funds generated from PSU restructuring could become a major source for creating relevant social infrastructure. Rs. 5000 cr can build 1 lac schools and 40 lac houses, without any further cash outflow on the part of the state. Putting this money in the general revenue account of the government does not make sense. The state should realize that it is basically not in the business of operation. In JNPT, the jetty given to P and O realized 60% more revenue than the rest. Now, the rest of the jetties are copying it. Therefore, operating technology is best left to the private sector, which continuously looks for ways and means to improve productivity.

Section 3: Urban Infrastructure

No major city in India has a 100% underground collection system for sewerage. As per one report, coverage of underground systems varies between 25% in Nagpur to 85% in Pune with a coverage in the region of 60%. The point is that installation of underground sewerage systems often does not get priority due to competing resources and thus fiscal support and people participation are the key to leveraging private sector participation in this sector. The total investment in the water and sanitation sector in the 10th five year plan is Rs. 30,000 cr and the public sector alone cannot fund this requirement. Hence the scope for the PPP models to intervene where it is feasible to do so, and free up the resources where it is not possible to have active participation by the private sector. The modern sanitation system will not function without adequate water supply. Conversely, the water supply would be polluted without proper sanitation facilities and cause problems by way of water borne diseases, etc. It is very important therefore to ensure the protection of surface water bodies and supply, ground water quality and sewerage management quality.

It is also very necessary to control the odor and mosquito menace and reuse treated waste water for industrial or landscaping purposes. In short, fresh water only need not be used when it is being consumed directly or indirectly, as water is now a scarce commodity. The commercial use of water can be paid for. While the capital and operating costs are high while introducing the high-tech equipment for such water treatment, the per-household cost can be decreased where there are more households, as the total cost gets spread over a large base. This is the secret of success in getting a viable private sector model going—the cost base must be lowered by having an extremely large customer base. The cross subsidy and soft loans to fund such projects make a better option as well, but it is undesirable to give anything totally free. However, the benefits of establishment of such equipment would only be there by maximizing coverage, with the inclusion of low income households as well and this makes for a sustainable structure at cheaper individual per-household cost. For example, at Tirupur, about 50 sites have been covered by the self-sustaining model having domestic and industrial effluent treatment plants and providing environmental benefits, water conservation and recycling benefits. In short, there is an urgent need to cater to the water and sanitation issues. We have the expertise and technology available for the same, but the real challenge is the funding which can be leveraged through innovative structuring of PPPs and user participation.

Photometry is another issue in urban infrastructure. For long, India has not been permitting aerial surveys to be done, for security reasons. This deprives the urban planner of a most useful and potential tool for making a master plan. Photometry is an art and science of making measurements in 3 D from aerial photometry and has been in use since the World War II. It is cheaper than traditional civil surveys but such maps are not available to public as 3D figure is considered as the security threat. However, new mapping policy in this regard is likely to remove such restrictions. The power of Photogrammetry is in correlation analysis, visualization like images, points and lines. The secret behind such photometry is that it gives a thorough analysis of the site and reduces the wastages in laying telecom lines, establishment of sewerage equipment and other relevant urban support systems. It facilitates better analysis of city planning, real estate, population, city museums, traffic departments, etc.

There was much discussion on how the US and Indian firms could leverage their strengths, to the betterment of Indian infrastructure. It was felt that the US could contribute significantly in:

- Management consulting services like initial project scheduling, due diligence, what-if-scenario and in establishing priorities.
- Strategic advisory services like project structuring, contract negotiations and creating a favorable financing scenario.
- Project finance assistance like equity and debt contributions and other innovative financial instruments.
- Comprehensive program management like highly specialized technical skills and top level diverse expertise.

In design and engineering methodologies, India had more than average capability and this was to be utilized properly, using proper project planning and management.

Section 4: Airports

The major talks in airport areas were the financing, infrastructure issues, bidding processes, legal challenges and land acquisition issues.

4.1 Financial Issues—Investing in Airports

Luis Miranda of IDFC AMC, Mumbai, discussed four major issues in investing in airports a) Regulatory and political b) Infrastructure issues c) Financial issues and d) Bidding issues.

As regards regulatory and political issues, such as dual vs. single regulators, tenor of regulator, regulatory stability, performance standards, golden shares of AAI/Government in any PPP were discussed. Airspace and defence were extremely sensitive areas and suggested that the government had to be necessarily involved. Management and allocation of land and right of way were particularly tricky problems, for large tracts of the land were required for airports. Also, travel-friendly policies and allocation of routes are very important issues to create a viable airport, and keep the money flowing in.

Financial issues include, Cost of project, revenue sharing, custom duties on equipment, stamp duty, income tax exemptions under various sections, lock in period for holding equity in the venture, debt/equity issues, type of collateral and fruitful use of the instrument of leasing.

Bidding process, Transparency in selection, tough technical screening on one price bid, sticking and providing realistic schedules so as to avoid cost overrun and other hassles.

Other issues include accountability for delays, unnecessary lobbying by losing bidders and by NGOs while resettlement takes place. This is a real time waster.

4.2 Legal Challenges in Developing Airports

The presentation covered the areas like public purpose-exposure to judicial review, land acquisition issues, center-state coordination, project financing risks, employment and taxation issues.

There are many issues which would affect a PPP partnership, especially when constructing an airport, and these were discussed briefly. Thus, evaluation of legal challenges and ways to overcome them, is the need of the hour.

Public Purpose—Exposure to Judicial Review

The public purpose of an airport brings with it the exposure of the developer to the process of judicial review just like any other public project. Therefore, it is incumbent upon the developer and state to display complete transparency, to avoid unnecessary litigation. The developer may also be subject to the process that governs the public sector on issues of operation, employment, etc. These have to be checked out carefully, before the final terms and conditions are decided upon.

Among the land acquisition issues is the live case of Bangalore where the process of land acquisition is cumbersome and involvement of multiple agencies makes it a complicated and sometimes lengthy process along with right of way issues leading to additional complexities.

Center-State coordination is necessary for the development of airports. While the concession is in the hands of central government, the provision of land and other projected related benefits is in the domain of the state governments. There is no universality of the benefits, extended by different state governments and the central government. In this context, airport specific concessions are far and few.

It is also important to factor the benefits and concessions in developer's business model due to uncertainty of benefits being extended through an administrative machinery of the governments.

4.3 Project Financing Risks in Airports

All airports are funded through institutional project financing. Due to vagaries and uncertainty of benefits available to the project, freezing of project cost is a major concern for all the developers. Risk mitigation is the most difficult evaluation issue with lenders and a conservative approach—the best from a lender's perspective, would lead to a high risk rating. The business models cannot factor in accurately the impact of continuation or withdrawal of state extended benefits on the viability of the project. However, usually certain subjective weightage is given.

4.4 Employment Issues

The employees of existing airports to be privatized are traditionally used to protections virtually on the same basis as government employees, and any change in the conditions of service for efficient operations is an uphill task. The situation could be better for Greenfield projects as conditions of service can be tailor-made to the developer's and operator's requirements. Operators of these airports can take advantage of the exclusion of contractual employment from the purview of retrenchment. Policy of hire and fire can nevertheless be challenged on grounds of fairness due to the public purpose for which airports are set up.

4.5 Taxation Issues

Some of the issues could be

- Structuring of tax efficient EPC contracts for the development of airports,
- Inconsistencies and limitations on project import benefits, lack of clarity on infrastructure project benefits,
- Uncertainty and diversity in state government tax regimes and benefits under different state taxes
- Withholding tax implications of diverse double taxation avoidance treaties,
- Discriminatory income tax regime for foreign companies opening branch/project offices for construction of airports leading to increase in the project costs.

In conclusion, there are many challenges that confront the various stakeholders of PPP in airports of which some illustrative issues have been addressed. Many other challenges would emerge as the process of PPP in airports gains momentum. Thus, addressing all these challenges,, would be part of the learning curve for developers as well as government.

Section 5: Financing Options

Reforms were started with power generation sector. This may have not been ideal, as it would have been better to fix transmission and distribution first. The key sources of the problem were the state electricity boards, which were unable to honor their obligations properly. This was one of the issues which affected the fast track projects, although it was not the only issue.

Another issue was the viability of the state guarantees, to make up for shortfalls in the user charges. Most of the state governments have a precarious fiscal position and therefore, this method of financing is running out of steam, besides being inherently not desirable. The investors are also getting wiser to the inherent value of these state guarantees.

While the power sector continued to dawdle, it was the telecom sector, which made the maximum progress. Initially there were a few hiccups, as exorbitant bids, which could not be sustained, were made by a few players, to capture the market in a particular circle. There were also various cross connections in authority among several government departments. But, with the Telecom Act of 1999, and the establishment of TRAI, the telecom sector has settled down very nicely, and continues to make a rapid progress.

5.1 Foreign Direct Investment (FDI)

With a better framework coming in, the FDI, specifically for the infrastructure projects, is expected to rise. With the large fiscal deficit and recurring government expenditure, it would be difficult for the state to fund anything more than a part of the USD 150 bn targeted. Some of this money would come, of course, from the Indian private sector, but a part has to necessarily come from the FDI.

Some interesting features had come out from the presentations made—

- The services sector now accounts for 51% of the GDP, thereby making India, a service economy. Industry accounts for 27% and agriculture 22%.

- The GDP growth rate for the current year is expected to be 7%. In the previous year, it was 8.5%.
- Over the last two decades, it has been around 6%, thereby firmly establishing India as a consistently growing economy.
- India is the only country in the world, capable of maintaining this kind of rate for a very long period.
- Industrial production is up and exports are substantially up (by over 25%). Foreign Exchange reserves are burgeoning.

In such an environment, it is expected that the FDI inflow into infrastructure would flourish. But, unfortunately, that is not quite the case. Although the scenario has improved it appears that the center and state governments are increasingly getting the message as to what the investors require.

Over the last few years, there has been a greater openness to FDI in the infrastructure sector. Now, most of the sectors permit 100% FDI or substantial FDI with automatic approval. Transport, power and the end use of urban infrastructure permit 100% investment, and telecom, airports and civil aviation have recently shown an increase from 49% to 74%. The investment can be made, and reporting has to be done to the RBI, within 30 days of making such an investment.

Several surveys of the international investors have revealed that there is an increasing satisfaction with what is going on as regards the policies and demarcation of what is permitted and not permitted. Policymakers are aware of the scope for further liberalization.

One of the relatively unnoticed features of the Indian policy making is the equal treatment accorded to the foreign investors vis-a-vis their domestic counterparts. This has substantial long-term implications, as it reflects a philosophy of non discrimination and a commercial outlook. This is not done, even in China. It makes them feel part of the community and go about their business in a day-to-day manner. Governments are increasingly getting away from "quick-fixes" such as sovereign guarantees. They are concentrating on laying down the broad policy and letting the market do the rest.

One issue with FDI, which has consistently worried the Indian policymakers is, the low level of actual conversion vis-a-vis the actual number of approvals. This was as low as 21% in 1997, but has improved greatly in recent years. The post approval procedures have been a major issue. Even so, great strides have been made in telecom, roads and ports. Power continues to be the area with the maximum bottlenecks. The lessons from Enron and AES do not appear to have been absorbed well. Funding is still done to State Electricity Boards (SEBs), which in their present state of organization, are just a "black hole".

There is, therefore, a need to get the government out of service provision to facilitate the FDI growth. There is also a need to boost the regulatory and legal framework, to adjudicate on disputes in a more effective manner. In order to do this, a greater role for the multilateral agencies could be envisaged. Other than just funding assets (which is what they are doing presently) they could tap their wide experience to assist the state in designing models and policy frameworks, which have worked in the developing countries in the past. The hard assets can then be commercially financed because the model is consistent with global best practices for that particular situation.

India needs to focus a lot more on capacity creation. There is a lot of potential for small and medium infrastructure projects, but the domestic contractor does not have the long-term capital to participate in them. There is, therefore, a need to create an effective source of long-term domestic capital for infrastructure, which would open the sector totally. FDI would basically be for the larger projects, though not always. Credit lines could also be setup by the export credit agency of the US for the import of construction and other equipment relevant to the infrastructure sector.

It was observed that after the opening up of the economy in 1991, there was a lot of interest from companies of the US, but after a few mishaps, this interest had died down. In the meantime, companies from Asia had continued to do excellent business in this sector, particularly in the last five years. Having gained the experience, know-how and contacts, these companies were poised to take the full advantage of the same in the coming years. The US companies would now have to move fast, in order not to lose out on the said opportunities.

Section 6: Recommendations

It appears that there is a great deal of awareness about the issues that need to be addressed, possibly more than there has been at any point earlier in time. Perhaps, the concerning parties, including the state, have arrived at a new depth of understanding as to what is really required to get the FDI going. The central government in particular, seems to have developed accurate awareness about the needs of overseas investors, and with this awareness now deeply embedded, it is only a matter of time before the solutions start coming up.

The broad recommendations are summarized as follows. The full details are mentioned in Annexure 1.

- Creation of a central clearing house of projects, which investors could look at, so that there is the maximum chance of finding one, which suits their requirements.
- Modifying some of the old and outdated acts (such as the Indian Ports Act 1908) to suit the modern day requirements.
- Center to enact model infrastructure enabling legislation.
- Use of modern methods of design and survey and permission to use the same.
- The role of independent regulators is to be expanded.
- Greater involvement of local institutions, when setting up projects, as they have the most to gain from the added infrastructure stock.
- Develop the art of tapping into revenue transactions, and other retail and service transactions, etc., to gain funding for infrastructure. The current education cess is a case in point.
- It must be remembered that when the investment comes in, the technology and management practices also come in along with it.

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For further details about the conference, please contact:
Ms. Neelu Sadana (mailto:neelu-sadana@dishnetdsl.net)
Indo-American Chamber of Commerce, 4/2 Siri Institutional Area,
August Kranti Marg, Room No. 403, PHD House, Opp. Asian Games Village,
New Delhi-110 016. Phone Nos. 26518201, 26963387, 26531965 Fax no. 26531954.
E-mail: indo-american@eth.net; iaccdelhi@vsnl.com

Annexure 1: Summary of Recommendations

- There is a huge potential for growth in the Indian infrastructure sector and phenomenal scope for India-US partnership in the sector. However, partnership needs to be localized and Indian oriented. PPP is the new mantra and it needs to be improved by integrated regulatory framework, strong autonomous regulator, cost based tariffs and transparency. Thus, ultimately it is the chase of feasible, and not the chase of the desirable.
- In roads and bridges—the key deliberations included design, technology, methodology and material, increased mechanization, method of contracting, selection of contractors, engineering planning and field survey, funding and financing, political will and commitments.
- In ports, among key deliberations include, the 1980 Act needs a new reincarnation, TAMP's role needs to be widened and hinterland needs to be connected to the nearer ports from the tourism point of view.
- Financing aspects can be better if bonds come from the retail investors, PF and pension money can be utilized as viable finance sources.
- In Urban infrastructure, successful PP models are already existing, but there is a need for user participation to sustain the economic potential.
- There is a need to restructure the utilities to attract investors as there is high resistance to internalizing past lessons. But, the current FDI policies are too supportive to attract FDI and must be leveraged by brand building.
- There should be a "central clearing house" of projects so that projects are modeled on standard lines and have secured government's "In-principle" clearance. The centre must enact model of "Infrastructure Enabling Legislation" so that it can unify different sector specific laws and all the states should be encouraged to formulate enabling laws on the lines of AP (IDEA), Gujarat (GIDA) and Maharashtra (MIDAS). For national road projects upto 60 m right of way, there must be exemption from the environmental clearances.
- Regarding the project development, large mega projects have to be necessarily developed and should be implemented by the government and organizations like MDRDC should be created to include high risk projects, de-risk them and then hand over to private sector for O and M. Given the challenges to infrastructure, performance based engineering design, cost optimization, high mechanization, industrialized method of construction and design standardization in case of rural roads, etc., have to be attended seriously.
- There must be an exclusive fund for project development and private sector needs to be compensated for its project development efforts if they are not ultimately selected in the bid process. There should be incentives for project completion "ahead" of time.
- PPP should be applied to procure "services" and not just "assets" and many innovative tools like variable revenue share and NPV can be used in some projects. The local institutions must be involved in formulating and implementing large projects so that there is some flexibility to suit to the local needs and conditions.
- External commercial borrowing norms should be made flexible to allow agencies like IFC to invest in Quasi Equity/Mezzanine debt.